S. HRG. 101-340

FOREIGN INVESTMENTS IN U.S. AIRLINES

HEARING

BEFORE THE

SUBCOMMITTEE ON AVIATION

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

LEVERAGED BUYOUTS AND FOREIGN OWNERSHIP INTERESTS IN U.S. AIRLINES

OCTOBER 4, 1989

Printed for the use of the
Committee on Commerce, Science, and Transportation

U.S. GOVERNMENT PRINTING OFFICE

23-662 O WASHINGTON : 1989

S261-12

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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FOREIGN INVESTMENT IN U.S. AIRLINES

WEDNESDAY, OCTOBER 4, 1989

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE,
AND TRANSPORTATION,
SUBCOMMITTEE ON AVIATION,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:09 am., in room SR-301, Hon. Wendell H. Ford (chairman of the subcommittee) presiding.

Staff members assigned to this hearing: Carol Carmody, professional staff member; Steve Palmer, senior professional staff member; and John Timmons, minority staff counsel.

OPENING STATEMENT BY SENATOR FORD

Senator FORD. Good morning, ladies and gentlemen. In July the Aviation Subcommittee held a hearing on the subject of airline takeovers and leveraged buyouts, and the implications of such activities on our inner transportation system.

At that time, I mentioned that the trend toward foreign investment in U.S. air carriers concerned me. It still does. In fact, since that July hearing the trend has intensified.

My fears have been echoed by other senators, as well as the Department of Transportation. Just last week the Secretary, who is here to testify this morning, issued a consent order for a buy-out of Northwest Airlines.

The buy-out was partially financed by KLM Royal Dutch Airlines, and the approval was subject to certain conditions which were placed on KLM. I am pleased that the Secretary gave this case such careful review, but I am still wondering if he needs additional statutory authority to continue to deal with buy-outs to come.

Just a few weeks ago a group which includes British Air put forward a proposal to buy United Airlines. The circumstances are different from the Northwest arrangement. The group also includes an employee group, but the concern about the large share of foreign equity is still there.

As I said at the July hearing, I want to know the implications of that level of foreign investment in our air carriers. How will it affect the management and control of the airlines? What does it mean for competition, when two international carriers who compete on the same routes combine operations?

Are we in this country opening our routes to foreign carriers without getting the same rights in their countries? It seems to me that the times and circumstances require caution and scrutiny.

We have a bill before the Committee now, S. 1277, which would give the Secretary of Transportation authority to approve airline acqisitions based on certain criteria. Perhaps the statutes governing foreign ownership and participation need expansion and clarification to keep pace with the changes of today.

I do not want to wake up when all the U.S. carriers have been leveraged and bought out, when foreign interests are manipulating our markets, when our carriers are shut out of similar markets in Europe and elsewhere, to decide that something should be done to regulate the buying and selling of major parts of our transportation network.

I am glad that Secretary Skinner is here this morning and I appreciate him adjusting his schedule to be here. We also hoped to hear from from the General Counsel of KLM, but he cancelled yesterday due to the on-going negotiations, now, with the Department and Northwest on the consent order.

I am very pleased that my ranking member is here this morning. Senator McCain, do you have a statement?

OPENING STATEMENT BY SENATOR McCAIN

Senator McCAIN. Thank you, Mr. Chairman. Thank you for holding this hearing this morning. I think it is highly appropriate that we are here today to consider the subject of foreign investment in our airlines.

I read a remark recently which stated something to the effect that events in the aviation arena are moving faster than the regulator's ability to develop policy. Very frankly, from some of the testimony we have had before this Committee, I think that is an accurate depiction of the situation.

This scenario seems all too reminiscent of the events a few years ago, when merger followed merger, and before we knew it, we had fewer airlines in control of a greater share of the market than before deregulation. In hindsight it is clear that perhaps several of those mergers should not have been agreed to by the appropriate regulatory authorities.

As you mentioned, Mr. Chairman, this subcommittee has spent a great deal of time over the last couple of years examining the issue of competition. It is in this light that I view the issue of foreign investment in U.S. airlines. I am not particularly concerned about foreign investment, per se. We have the 25 percent rule which deals with that.

What I am concerned about are investments by foreign airlines. I am concerned about what these parties think they are receiving in exchange for their investments. My concern is heightened when this activity occurs between airlines which are real or potential competitors.

I would like to take this opportunity to commend the Secretary of Transportation for his activist attitude and apparent desire to preserve and promote competition in the airline industry.

Whatever one's view of the conclusions reached in the Northwest review, there can be no denying that Secretary Skinner pursued his responsibilities with vigor.

However, Mr. Chairman, I believe we should have a clearly enunciated policy, which we do not have at this time. It should be a policy that does not depend on who is a party to the transaction, a policy that does not depend on which foreign leader is involved, it should be a policy based on what is best for the American traveling public.

I agree with the Secretary that every transaction should be reviewed on its merits. However, I also believe we can be more explicit in our review criteria. Competition is the key to a healthy industry and every transaction should be analyzed with this in mind.

Mr. Chairman, again I would like to reiterate what you said and the way I feel. There is no doubt that airline competition is going to become international in scope and nature. We have to carefully examine the impact of the investment of foreign airlines in U.S. airlines in order to ensure that when marketing decisions are made, those decisions are made in the interests of the consumer and not in the interest of a foreign airline that may have an interest in a U.S. domestic airline.

Thank you, Mr. Chairman, and thank you for joining us this morning as always, Secretary Skinner, and Mr. Shane.

Senator FORD. Mr. Skinner, please proceed with your testimony. If you want to summarize, it will be fine—we have read your statement—so we might have some time for questions before you have to leave.

STATEMENT OF HON. SAMUEL K. SKINNER, SECRETARY, DEPARTMENT OF TRANSPORTATION; ACCOMPANIED BY JEFFREY SHANE, ASSISTANT SECRETARY FOR POLICY

Secretary SKINNER. Thank you, Senator Ford and Senator McCain. I will, with your permission, summarize my thoughts.

With me is a gentleman that is familiar to both of you, Assistant Secretary for Policy Jeff Shane, who testified before your Committee recently and has been involved, as have I, in the recent KLM/Wings/Northwest transaction.

Let me say that, first of all, the situation the Department of Transportation and this country's airline industry finds themselves in is somewhat unique. We are clearly in a deregulated environment.

It is an environment which I believe is of absolute essential necessity for this country and the future of airline travel, as we compete in the world. It has, according to some experts, resulted in benefits to consumers of as much as $14.9 billion on an annual basis. It is a concept that the Administration is totally supportive of, and we will continue to be so.

At the same time, we find ourselves with certain statutory responsibilities that we intend to fulfill to the best of our ability, and that of course deals with the issue of safety and making sure that under our current fitness authority airlines that fly, fly safely and put the right amount of money into maintenance and the other issues relating to safe, efficient operation, that these people are in fact qualified to run an airline; and, finally, that the law, as is developed under the statutes and by case law at the Department and previously at the Civil Aeronautics Board as it relates to foreign

ownership and control, is enforced. Those are the guidelines that we have followed in analyzing the Northwest transaction.

I suggest that each one of these transactions has to be analyzed on an individual basis. I recognize, as Senator McCain indicated, that policy is important and we are, I believe, enforcing the policy as it exists already. It may not have been articulated, but if you look at the transaction that exists in the Northwest situation, I think you will find there is plenty of support under the law, in the case law and other decisions at the Department, to support the decision we took, especially as it relates to foreign control and ownership.

On the other hand, clarity is important, and I think it is essential, because it is very difficult, we have found, having gone through the Wings transaction, to try to define after the transaction is complete what Department policy is and what it has been, because even lawyers generally will differ on interpretation of cases and earlier precedent.

Let me say that I am satisfied that we are staying ahead of what is going on in the airline industry. We obviously learned a great deal from the Northwest transaction, not only as a process, but a great deal about the airline industry, its current financial situation, the impacts of recapitalization, as well as some of the pitfalls that face the industry.

We are totally committed to making sure that we analyze these transactions on a quick and efficient basis, but as indicated in the Northwest transaction, the amount of material we requested and the analysis required are voluminous, and I might add somewhat expensive, to complete that review.

I am hopeful that by having done the Northwest transaction we will be able to do the next transactions on a more efficient basis.

Finally, I think that it is important to recognize that the airline industry in this country is a very precious commodity. I read in the paper this morning about another airline, Presidential Airlines, that is stationed out at Dulles, that is having significant problems and has taken significant cutbacks. That is a situation we have and will continue to monitor on a regular basis.

I noticed in that article that they referred to Presidential as only the third of some 100 airlines that had either started or begun to service traffic over the last several years and they were one of the three remaining.

Whether that number is true or not, it is clear that the ability of an airline to enter this market, or a group, even with proper equipment and proper personnel and proper management, to enter the airline industry in this country is extremely difficult.

There are a number of barriers for new entrants which we have talked about with this Committee in the past and by the end of the year I am hopeful we will have what I call our pro-competition policy into place so that we can make sure we are doing everything we can in a deregulated environment to enhance new entrants and make it possible, and even probable, that they will succeed or have a good chance to succeed.

Therefore, it is important, if not imperative, given that and given the fact that they represent the only really significant military airlift capability in this country, that we enforce strongly the foreign

ownership rules and that we not allow foreign control or ownership of these airlines in violation of the law.

I think that the Department is ready to answer any questions that you have. Mr. Shane is here to answer any of the questions that I am not able to answer.

[The statement follows:]

STATEMENT OF SAMUEL K. SKINNER
SECRETARY OF TRANSPORTATION
BEFORE THE SENATE SUBCOMMITTEE ON AVIATION
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

OCTOBER 4, 1989

Mr. Chairman and Members of the Subcommittee, good morning. Once again I thank you for the opportunity to come before you and discuss the Department's thinking on two vitally important aviation industry issues. One issue is the degree to which leverage is used in the capital structure of U.S. airlines. The second is foreign ownership and control of U.S. air carriers.

At the outset, allow me to outline some of the Department's thinking on these two issues. The airline industry was deregulated 11 years ago. We believe that deregulation has been successful, demonstrating that the application of market forces has worked well in making the air transportation system healthier, more efficient, and more responsive to the demands of passengers and shippers. In a recent assessment of the effects of airline deregulation on travelers and carriers, Morrison and Winston have estimated the annual benefits at $14.9 billion (in 1988 dollars).

Some airlines have been financially successful; others have not. Overall, market forces have benefited airline customers, owners, managers, employees, and investors. The industry's success has attracted new and more sophisticated investors, including some foreign groups and even foreign airlines.

Since the Department believes in the efficacy of the marketplace in generating the greatest good for the greatest number, we have been loathe to interfere in the dynamics of the market decisions, except where statutory obligations require us to do so.

Let me turn now to recent events. On June 19, 1989, NWA, Inc., the parent of Northwest Airlines, announced that it had entered into a merger agreement with Wings Holdings, Inc., a corporation formed for the purpose of acquiring Northwest Airlines.

Although leveraged transactions have become quite common during the 1980s, the Wings proposal was the first LBO-type airline acquisition of this magnitude. The Department's response to the Northwest announcement was to begin promptly a continuing fitness and citizenship review of Northwest under authority of section 401 of the Federal Aviation Act. We quickly recognized that the magnitude and the potential impact of the transaction could cause a significant change in the operations and character of the company.

First of all, the proposed acquisition involved a four-fold increase in Northwest's long term debt and a significant increase in its debt service requirements. The pressure to pay down the principal and to meet interest payments could threaten the

carrier's ability to meet its other obligations, including fleet replacement, aircraft repair and maintenance, security, crew training and other safety-related expenses.

It is the Department's policy to routinely intensify its scrutiny of carriers when there is reason to believe they may be experiencing financial distress, and excessive debt in a cyclical industry such as airlines is a cause for concern. Mr. Chairman, I can assure you that air carrier safety is something I will never compromise during my tenure as Secretary of Transportation.

As you know, the Federal Aviation Act does not require air carriers to seek advance Department approval of any ownership change. Completion of the transaction, however, did not preclu the Department's review of this case. The Department's staff continued its comprehensive analysis of the Northwest transaction, as well as consulting extensively with numerous outside sources on the underlying issues. These sources included experts from other federal agencies, the academic community, management consulting firms, accounting firms, economists, stock market analysts, and aviation industry consultants.

We also decided to retain the services of a well-known public accounting firm (Coopers & Lybrand) to assist us in our comprehensive review of this transaction.

All of the above measures were taken because we were treading on sensitive ground, and we wanted to be absolutely certain that all of our steps were firm, deliberate, and well-conceived.

The second major area of concern with the Northwest transaction was the $400 million equity participation by KLM. KLM was by far, when both common and preferred stock are considered, the largest equity player, holding about 57 percent of the total equity investment. KLM is one of the largest European air carriers with a wide route system throughout Europe and across the Atlantic. Northwest is the fourth largest U.S. airline and a significant competitor in transatlantic operations.

The Federal Aviation Act requires that certificates of public convenience and necessity to engage in air transportation be held only by citizens of the United States. Congress wished to safeguard national security by ensuring that U.S. air carriers would provide aircraft to the U.S. armed forces in times of war or national emergency. Congress also wanted to ensure that U.S. air carriers would be able to compete vigorously with foreign carriers on international routes.

Section 101(16) of the Act requires that the President and two-thirds of the Board of Directors and other managing officers be citizens, and that at least 75 percent of the voting interest be owned and controlled by U.S. citizens. During the past 50 years, this Department and its predecessor, the Civil Aeronautics Board, have consistently interpreted section 101 to mean that the carrier must actually be controlled by U.S. citizens.

While KLM's voting share technically fell within the statute's numerical limits, we concluded that KLM's ownership of 57 percent of NWA Inc.'s total equity, together with the existence of other links between the carriers and KLM's position as a competitor, could create the potential for the exercise of influence and control over the carrier's decisions. This would be inconsistent with the law.

In short, the congruence of both the significant increase in Nothwest's long term debt and KLM's substantial and unpecedented equity investment in Northwest raised important concerns.

Rather than immediately moving forward with procedures that could lead to a finding that Northwest's debt leverage required closer DOT monitoring or that Northwest was no longer a U.S. citizen under the statute, I personally discussed my concerns with Mr. Alfred Checchi and other principals of the company. Together we

reached an agreement that accommodates the Department's concerns and comports with the statute and legal precedent.

Our deliberations regarding the transaction culminated in the announcement last Friday, September 29th, that the Department had reached a consent agreement with Northwest. Under the agreement:

- KLM will reduce its equity in Northwest to 25 percent of the total equity;
- KLM may still have one representative on the board of directors, but that person must effectively limit his or her involvement to matters relevant to protecting KLM's pecuniary interest, recusing himself or herself when the board is dealing with certain matters, such as bilateral negotiations and competitive issues;
- KLM will dissolve the three member advisory committee to Wings; and
- Northwest will make available annual forecasts and budgets, along with quarterly and year-end financial statements and other information.

This detailed reporting was imposed to enable the Department to monitor Northwest's continuing financial fitness and to provide the Department with early warning of any problems that the new Northwest may be encountering in servicing its debt and meeting its safety obligations.

I would like to emphasize that the Department believes that there may be potentially significant benefits to be derived from airline financial restructurings, including leveraged buyouts, and from attracting foreign capital investment to U.S. airlines. Because leveraged companies must become more efficient in order to generate additional cash flow to pay down the debt, enhanced competitive behavior may be stimulated. Operations may be streamlined, waste eliminated, and organizational focus sharpened.

Similarly, the potential benefits of foreign investment are equally obvious. The whole panoply of benefits from any new investment becomes evident -- new jobs, new spending, and new growth. Additionally, encouraging foreign investment has a positive impact on the U.S. balance of payments, and travelers can look forward to improved air service.

Our purpose is not to create arbitrary obstacles to foreign capital investments that might otherwise be available to the U.S. airline industry. But as I have already stated, under the law, the Department must assure that a carrier is "fit, willing, and able" to perform service and that the law on foreign ownership is adhered to. To that end, the Department will review each acquisition on a case-by-case basis bearing in mind the factors I discussed earlier.

Keep in mind that even with the agreed upon reduction in KLM's equity participation in Northwest, substantial foreign investment will remain, both in the form of debt and equity. Foreign participation in Northwest's total capitalization (debt and equity combined) will still be over 60% of the total.

Finally, I assure you that it is not our intention to impose barriers to realizing the economic growth possibilities inherent on the bright side of leveraged buyouts and foreign investment in our airlines. Rather, a traveling public confident of a vigilant, but not intrusive government will continue to spur continued growth and expansion of our precious air transportation system.

Mr. Chairman, thank you for your kind attention. My staff and I are ready to answer your questions.

Senator FORD. Thank you, Mr. Secretary. I am not sure exactly how you said it in your remarks, but you said that your people define the proposition after the transaction and that it is subject to various and sundry interpretations.

Would it not have been better for you to be in at the beginning or for your people to be in at the beginning rather than to come in after the fact, after an agreement has been reached?

Secretary SKINNER. There is no question that the more lead time you have, the quicker you can reach a decision. Part of it deals with: one, when the people conducting the transaction have enough information to provide us with information; and two, how quickly they can get it to us.

I think in the Northwest transaction there was a lot of speculation in the newspaper and there was a lot of conversation early on, but until a deal was consummated by the board with Mr. Checchi and the Wings group there was not a lot of detailed information that was available for us to analyze.

What I meant to say was that it is more difficult, Senator Ford, to unwind a transaction that has already been put together than it is to be there from the beginning before the transaction is put together. In some cases that creates a little hard will and misunderstandings and things like that.

Senator FORD. You have just answered my question, that it is hard to unwind. If you are there winding it as it starts, there would be somewhat of a different approach, I think.

Now as of yesterday the general counsel for KLM had to cancel his appearance before this committee today. He gave as a reason they are now studying restructuring that you imposed or suggested and apparently Mr. Checchi has agreed to but KLM has not agreed to. That indicates that if KLM does not agree to the new proposal the deal will fall through, because most of the up-front cash, 68 percent or some figure like that, was the amount of cash, up-front money, to make the arrangement.

Now we find ourselves with the possibility of that not going through. Is that good business?

Secretary SKINNER. The way you put it, it does not sound like good business.

Senator FORD. I think I have given——

Secretary SKINNER. Let me put it another way.

First of all, Wings is the new owner of Northwest Airlines, and that is the primary party with whom we deal. Their investor is KLM. While we have had some brief conversations with KLM, under the law our relationship is to deal with the license holder's new owner. They are comfortable that, number one, it can be restructured.

Number two, it appears that they have some more negotiating to do with KLM, and we have given them a period of time in which to unwind the transaction so that they can find a substitute for the equity of KLM which will be removed from the deal.

All of that creates a certain degree of uncertainty, Senator Ford, which is I think is what you are getting. I am comfortable that all of that will occur in due time, consistent with the consent decree with which Wings agreed; but it is not nearly as clean as I would

like it to have been had we been involved earlier on a prior approval basis, whether that be a formal prior approval or not.

Senator FORD. I am trying to give you some legislation that would give you that kind of prior approval and involvement. I would hate to have your people be vigorously opposed to it.

Secretary SKINNER. I do not believe I said anything——

Senator FORD. I did not say you. I said "your people". The buck stops here.

The foreign press particularly in the United acquisition are playing this as a merger, not an investment. They look at this as a merger between two airlines when you keep telling me it is just an investment. When you have two airlines competing for the same route and then they become partners, does that not indicate that it might be a merger or a merger in the eyes of others?

Secretary SKINNER. There are other transactions that are pending before the Department. There is a regulatory process. As I said, I do not think it is appropriate while those transactions are pending to comment. I think I can answer your question without doing that and violating Department policy or rules.

In the KLM transaction we became very concerned about the fact that a director and officer of KLM would be sitting on the Wings board and would be discussing matters regarding how Wings and Northwest would compete for routes in Europe and other parts of the world while at the same time that person also would sit on the board of KLM talking about how KLM would compete with Wings and others in the domestic and foreign markets that they serve.

We structured what I think is a complete recusal process, so that the director will be required by consent decree to recuse himself, and the certificate will be at risk if, in fact, that director does not recuse himself from any conversations regarding competition or possible competition between that airline and KLM. That is the normal process that we think will and can work in the industry.

So we think it is a real problem, and that is the reason we suggested and they agreed to abolish the financial advisory committee of three, why we thought that the equity should be replaced, and why we thought the director from KLM should be recused on any matter before the board which would relate in any way to competition with KLM.

Senator FORD. It is my understanding that one airline is the predominant builder of aircraft of KLM, and that Northwest has had some orders in for Airbus, and KLM's aircraft favorite or those who build for them is another.

I understand that Airbus contract has been cancelled and that they are moving to Boeing, which is the KLM aircraft builder. Do you have any——

Secretary SKINNER. No. I asked Mr. Shane, and neither he nor I are aware of that at all.

Senator FORD. Well, I think you ought to be aware of it. That indicates influence, does it not?

Secretary SKINNER. Yes.

Senator FORD. Of a minor nature as far as funds are concerned?

Secretary SKINNER. If in fact the contract was cancelled and it was moved to someone else, we would have to get behind the trans-

action to know the reasons, but it certainly raises questions you would want answered.

Senator FORD. I have raised the question. I sure would like to have the answer.

In your testimony, Mr. Secretary, you say, and I quote, "Our purpose is not to create arbitrary obstacles to foreign capital investments that might otherwise be available to the U.S. airline industry."

What sort of obstacles do other countries present for U.S. investments in their air carriers; and could a U.S. carrier buy 25 percent of a European carrier?

Secretary SKINNER. We owe you a report on that, as you know.

Senator FORD. It was due in July.

Secretary SKINNER. Mr. Shane tells me that he expects to have it out either today or tomorrow. It has required us to inquire of many of our missions throughout the world.

The synopsis or the summary of each of these rules, if one were to look at it collectively, they would say that American investment in airlines is treated about the same in foreign countries as we treat it in this country. There are some countries which are a little more liberal. There are some countries which are more strict. There are some that are about where we are. If you put it all together in a pot and averaged it out, it appears that the foreign investment criteria in foreign countries is about the same as the criteria we have here.

Senator FORD. Except none are available.

Secretary SKINNER. You make a very good point. A number of these airlines are national airlines or closely held stock, so it would be unrealistic to think that we could buy significant positions in some of those nationally owned airlines.

Senator FORD. Have you had any response from any foreign entities since your consent order on Northwest and KLM? Have you had any indications preferably that this might discourage future investments?

Secretary SKINNER. No. I think that some clarity and understanding resulted from the announcement of our decision last week. I think it sets and establishes in order form what Department policy and CAB policy has been and kind of puts it in a real time transactional mode.

I have, however, heard no real complaints. I have heard several people comment that they are delighted the decision came out so they can understand it. I think a number of people understand that each of these transactions has to be looked at on an individual basis but that a better understanding has resulted of our foreign ownership and investment rules as a result of our decision.

There have been some uncertainties, I might add, Senator Ford, concerning whether or not we were going to reregulate the airline industry, which is not our intention.

Senator FORD. I hope you factor this into your decision. How do you assess the effect on competition of two carriers with similar international routes forming basically a partnership or an interlocking arrangement of some sort? Would this not result in further consolidation among carriers, less competition and less choice for the flying public?

Secretary SKINNER. Well, I think there is a risk any time two people are competitors and are sharing strategies of each other's company and they have investments in each other. To me those are the indicia of less competition. That I say as a lawyer who did some antitrust work when I was in the private sector. The idea of interlocking directorates having full access to information from both companies that compete against each other just from a common sense viewpoint does not appear to me to make sense. That is why we structured the transaction the way we did.

On the other hand, investment per se is important. Sixty-five percent of the debt and equity in this transaction is from foreign sources. Most of it is the fact that the debt in this case is from Japanese and European banks. It is leverage and it is restricted so it does not conflict with U.S. ownership. But this free flow of capital between countries is very important and we have got to make sure we do not restrict that and at the same time, in allowing this flow, we set up procedures so we do not lose control of these valued assets.

That is a tricky road to walk.

Senator FORD. Well, you just mentioned two of our major problems—Japan and Europe. There we are running third now and they are making investments and they continue on that path. Everybody says that is the open market. Well, when foreign markets sell more stock and bonds to underwrite our debt than any other operation, including the United States, does that not give you some pause for concern?

Secretary SKINNER. Well, I think the balance you have got to draw is the cost of capital in these foreign markets and the fact that much of this money that is coming back to this country and being reinvested in America is money that left America because of the consumer.

So, therefore, as long as we do not lose control and we take advantage of low-cost capital which allows us to efficiently price our product, I think as long as we have done all those things I am not as concerned because I think if we were to restrict investment in the airline industry and debt in the airline industry to just domestic banks it would cost the American consumer significantly in the cost of product.

So I think we have got to find a way to have that free flow of capital and at the same time make sure we do not lose control.

Senator FORD. But that capital is being used by foreign ownership that is buying into our American operations.

Secretary SKINNER. Well, they may buy and they may get a return on their investment, but as long as they do not make the decisions and they do not control the airlines and we pay less for that capital than we would in the domestic market, I think everybody comes out ahead.

Senator FORD. If you found that Airbus was cancelled and the contract was transferred, then you will find out what kind of influence has already been exerted and you have not allowed the deal to go through yet.

Secretary SKINNER. You have piqued my interest, Senator.

Senator FORD. Okay. I want to pique your interest a little bit more. Concerning what you have just been through with Northwest

and Wings and what is coming up, why is there resistance of any kind to legislation that would give you specific authority at the time that you would need it and where you could pick it up rather than after the fact?

I think you have already testified that the only thing you could do is jawbone or lift the certificate, and apparently you are a pretty good jawboner up to now. But if they lose the deal, what effect will this now have on United, based on what you have done with Northwest?

Secretary SKINNER. Well, the question on jawboning, we do have effective authority and I do not want anyone to leave here with the impression that we do not have authority, because we do.

Number two, as I have indicated to you, it makes it more difficult because in many cases the lawyers structure and they do not properly warn all of the parties that this is subject to departmental review. Now any lawyer who puts together a transaction today and does not indicate to everybody that this is conditional on a review of the fitness certificate by the Department, who has announced that it will do so in all such transactions, is guilty of malpractice.

So I think we have sent the clear message before that. Because there basically had been no transaction like this and the Department had taken no position, they might be in a position to say, well, it is really not a problem. I do not think anybody who reads the financial news today cannot understand that this is conditional upon the Department's review.

On the other hand, I have frankly looked at the legislation. I understand and have made clear to you, I think, Senator, that it would be easier to have an approval process earlier than we have had. I have not, frankly, had an opportunity, given all of our energies were in the Northwest transaction, to get my thinking clearly. But I can tell you that from a procedural viewpoint, procedurally it would appear to be cleaner.

Senator FORD. Under your fitness rule what authority do you have to stop it other than what you have done? Do you have a legal basis on which to operate?

Secretary SKINNER. Well, you can just declare, if the record supports it, that the airline is unfit to operate and prohibit it from operating.

Senator FORD. You jerk its certificate, then. That is the only authority you really have.

Secretary SKINNER. Well, in all fairness, Senator, that is a substantial amount of authority.

Senator FORD. Oh, I understand that. But it has some ring of finality to it.

Secretary SKINNER. You are right. You can also condition the certificate as well. But that is subject to, as you point out, all kinds of procedural challenges.

Senator FORD. Senator McCain.

Senator MCCAIN. Thank you, Mr. Chairman, and thank you for appearing before us again, Mr. Secretary. I always appreciate your counsel and expertise.

Mr. Secretary, I think I just heard you say that it would be helpful for you to have some kind of prior approval authority.

Secretary SKINNER. I think I said it would be cleaner if the statute had prior approval process. It would be cleaner and more efficient and less disconcerting to all involved. That is what I said. In my personal opinion, having been through one and having to now have to find myself giving KLM six months to unwind, it clearly would be cleaner.

Senator MCCAIN. I think a major point has to be made here, and that is it would have been easier for all parties involved—KLM, Northwest, Wings, everybody—if these restrictions had been placed on them at the time the deal was being consummated rather than ex post facto. Would you agree with that?

Secretary SKINNER. There is no question if they had known earlier what the Department's position was on the structure, they would have structured it that way, I believe, and would have created a lot less concern and possibly, I suppose, run the risk of the transaction in some cases—not in this one, but possibly in others—unwinding.

Senator MCCAIN. And while, as you said, your energies were devoted to the Northwest transaction, a United Airlines transaction took place in which, according to my information, British Airlines put up 78 percent of the equity. So we are clearly seeing a trend here which perhaps should be addressed from a policy standpoint, since obviously the Wings-Northwest transaction is not an isolated case. Would you agree?

Secretary SKINNER. Yes. I think we are really defining--first of all, I agree that the industry, the investment community, and airlines all have a right to know what the Department's position is, and the clearer that is, the easier it is and fairer it is.

Number two, in my opinion, we have got to make sure that in doing that we do not by policy create a policy that now the lawyers and investment bankers and everybody can get around or restructure to get around the current policy, get the same result and then come down and say well, it does not say that in the policy. So that is why this case-by-case analysis I think makes some sense. But the policy guidelines from current and past precedent I think can be—a good lawyer, or not even a very good lawyer can look at that transaction, in my opinion, and draw some conclusions as to what the Department's policy is.

Senator MCCAIN. I was interested in your off-the-cuff remarks concerning Presidential Airlines. Also, last week Braniff Airlines went Chapter 11 for the second time. This trend should be of enormous concern. I am also pleased to hear you say you would support policies that would encourage a competitive environment in the airline industry.

You and I have had several conversations about the factors that exist now which basically are anti-competitive, whether they are CRSs, or slots, or source codes, or a variety of other factors.

I would hope that you would look with some favor, or at least scrutiny, on some of the proposals that I will be putting into legislative form, because, frankly, I think we are reaching nearly a crisis situation with the number of airlines decreasing and, apparently every major, healthy airline in America—five remaining that are healthy—being the subject of an LBO.

We saw American Airlines stock go up and down. We saw what happened with United Airlines and Northwest. The others, I am told, are waiting in the wings. I hope that concerns you just because of the fact that it does not seem appropriate for every major airline in America to be in debt up to their eyeballs. Does that make sense?

Secretary SKINNER. Well, let me see if I can address it along two fronts, and let me put the competition aside a minute and talk about the recapitalization.

Recapitalization in and of itself may not be bad. The investors in these airlines, the stockholders, have a right to a return. And one of the problems is because of dividend levels, you know, the company has been placing a substantial amount of time and money and their resources into buying airplane positions and other things, they have not been giving a return to their shareholders. As a result of that, the assets are worth more than what the shareholder is getting in dividends on a return basis, so the recapitalization by its nature occurs.

Recapitalization may make management more efficient, may challenge management more to do a better job. The problem is when it swings over from a proper recapitalization to a heavily leveraged, excessively leveraged situation. A lot of things can occur.

I have been involved in representing leveraged buyout teams in the past in the private sector, and I know when that debt service obligation comes up and they are short on cash they basically try to find the cash wherever they can, and that is what concerns me.

So therefore a proper amount of recapitalization may be, in fact, the debt may be less expensive than some of the other ways that have earlier occurred. On the other hand, if it goes too far it creates major problems and the airline can never recover.

Part of the problem that is being created, as you point out, is the fact of the condition of our competition. I am not happy with the situation we find ourselves in in this country, where in certain selected markets one airline occupies as much as 85 percent of the market and there is no parallel market within 50 miles.

That is what the competition study is all about. The policy people at the Department have finished the second phase. They are on to the third phase. That will look at slots, it will look at gates, it will look at CRS, it will look at code-sharing, it will look at a lot of the issues that I think restrict the ability of airlines to move. And I am hopeful by the end of the year to have that.

Senator MCCAIN. Well, I hope so, Mr. Secretary, and I think it is very important that you are on record as sharing the concern of this Committee about the trend we have seen of the disappearance of competitive airlines, the reduction of a competitive environment, and, what I believe you are saying, that steps need to be taken to reverse this tide. Is that accurate?

Secretary SKINNER. Yes, that is accurate, and I think the Department's record on transactions facing it demonstrate that. We advised the Department of Justice we thought there were significant problems in the gate transfer from Eastern to USAir at Philadelphia. We stated our position to the Department of Justice on the CRS merger that American had proposed.

Senator MCCAIN. And we very much appreciated both of those decisions. I would like to add—and I apologize for interrupting—that that was really a reversal of what had been generally the Department of Transportation's record in the past.

Secretary SKINNER. I understand it is a slight departure. I do not know if it is a total reversal, but it is a slight departure.

Senator FORD. You are a slight departure.

Secretary SKINNER. I do not know if that is good or bad, Senator.

Senator FORD. It is good.

Secretary SKINNER. Some say it is bad.

Senator FORD. Well, you and I do not agree, but I still like you.

Secretary SKINNER. Well, we agree more than we disagree, don't we?

Senator MCCAIN. On that high note, I think I will conclude my questioning. Thank you, Mr. Secretary. I just would like to reiterate again I think in the coming weeks and months on this issue it is very important that we work very closely together. If we are going to achieve the goal that we both share, we have to work together rather than in competition, and I hope that bureaucracies and turf will not interfere with us achieving the goal which we both share.

Secretary SKINNER. Well, I think that is true and I think that is a good point. On occasion there has been a lot of give and take in the last nine months because the Department and this Committee and other committees. I think in areas where the goal can be better accomplished by legislation I have deferred to legislation, in fact one in particular, and in others I think it can be more effectively done by regulation.

But I have gotten to know your staffs, both the minority and majority staffs of the committee, very well, and I know they have a good respect over at the Department, and I hope my staff has the same. So I think we will have that working relationship. It is the staffs that will make that work as well as us. Thank you very much.

Senator MCCAIN. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

Senator FORD. Let me ask you one quick question before you leave. Can you make any comment about the Braniff bankruptcy and what kind of debt they had and its relationship to competition? You referred to Presidential Airways which you read about in the paper this morning.

Secretary SKINNER. And only because I read it in the paper and it was just timely. I did speak to Mr. McGee, the President of Braniff, last week. They are keeping us advised on a regular basis. It is a very, very difficult situation they find themselves in.

They thought some things were going to happen that did not happen. They just did not have the cash flow to make a very significant payment that was due, I think, this week. So they really felt they had no choice but to go through the reorganization the second time.

Obviously their market is different now. You know, they moved to a different market. They left Dallas-Ft. Worth, where they were for many years. I would only observe that that is probably a good example. In order to compete against the airlines at Dallas-Ft.

Worth you have to have resources to be able to offer a significant number of flights so you can compete with the every-hour departure that the other airlines offer.

In order to do that, you need equipment, you need gates, you need slots in some cases—not at Dallas-Ft. Worth but at others—and if you do not have access to that you cannot put a schedule together that will allow you to compete.

Then I would just finally say that because they can spread the cost, the major airlines can spread the cost of a particular route structure across the system if they want to pinpoint market on price in particular for new entry purposes or something else, they can make it very tough for these new entrants. We have got to find a way.

Senator MCCAIN. You also have to have an appropriate and competitive position on the computer.

Secretary SKINNER. Right. Well, that gets into the whole CRS, which we are also looking at and which we have talked about.

Senator FORD. Thank you, Mr. Secretary. We appreciate your coming and we will be seeing a lot more of you.

We will wait until the Department of Transportation leaves. Did you bring them by bus?

[Pause.]

Senator FORD. Mr. Pettee is in the transportation investment area of Merrill Lynch. Ed Beauvais is President of the America West Airlines and will discuss the advantages of international investment in the airline industry and various financial arrangements.

Mr. Pettee, would you like to proceed, and then we will get to Mr. Beauvais. Your statement will be included in the record in full. If you want to highlight it that will be fine, and we will go from there.

STATEMENT OF TIMOTHY PETTEE, FIRST VICE PRESIDENT, AIRLINE INDUSTRY ANALYST, MERRILL LYNCH CAPITAL MARKETS

Mr. PETTEE. Thank you, Senator. Just a quick point. It is Pettee, not Petrie.

Senator FORD. All right. You were not born and raised in west Kentucky.

Mr. PETTEE. I would like to have my formal remarks submitted into the record, and I thank you and the staff for the opportunity to address you today on these very important issues that are facing the industry.

First off, I would like to applaud the efforts of your legislation, S. 1277, because, clearly, some clarification of policy is needed in the airline industry today. It appears that the airline industry, airlines in the U.S. and abroad, are pursuing a different agenda than perhaps we would otherwise like them.

I am aware the committee has addressed aspects of the leveraged buyout phenomenon in the airline industry in previous hearings. I just thought I would take a brief moment to back up and look at just what is going on on Wall Street, just what is driving the LBOs

and, for the purposes of the committee, driving the foreign investments.

As Secretary Skinner mentioned and we are all well aware, the airline industry in the U.S. has been essentially revalued. In the process, it is being recapitalized. There are a few primary reasons for this revaluation and recapitalization which I detail in the testimony.

To summary, one is that there is a belief that the cyclicality in the industry that has been present in the past may not be present in the future and that the earnings and cash flow that the industry has recorded in recent years is sustainable for the foreseeable future.

Secondly, there is a significant realization of asset values, airline assets. Aircraft, gates, slots, everything that an airline uses, pretty much everything, has increased tremendously in value. Airlines looking to capitalize on these increases are realizing these asset values raising cash and providing capital.

Third and lastly, there is a significant amount of capital debt and equity and, importantly, leasing capital available in the airline industry today. It is a very attractive industry from a debt, equity and leasing standpoint, and that is driving the LBO trend or the recapitalization trend in the industry.

It is not just here in the U.S. The result has been that airlines have become very attractive investments worldwide. One need only look at the privatization of British Airways and of Air Canada which resulted in very significant investment interests in those respective countries.

It is very difficult for anybody to predict industry behavior, but the effect of the LBOs and the foreign investments are as follows.

Clearly, there is a possible reduction in growth for the U.S. industry and a possible concurrent reduction in capital spending. Capital is not unlimited in the airline industry, in any industry. The financing plans that airlines, American, Delta, America West, whomever, set forth a year or two years ago certainly probably did not include significant leverage in the future development of that plan.

This would likely result in some reduction in the industry's growth. I do not think that would be all that bad. The fact is that as I look at and take a stab at forecasting this industry, the U.S. airlines are clearly on the path of adding more capacity than the traffic forecasts suggests will be out there.

In other words, we are looking at adding 8 percent more seats over the next four or five years. Traffic is forecasted to grow 5 to 6 percent. It may not be all that bad if we rein in some of this capacity growth.

Secondly, LBOs and leveraged airlines will become much more cash flow oriented than we see today. This would lead to, I think, some cash flow pricing initiatives. There is a very popular theory I have heard on the hill, in the media and on Wall Street that more debt leads to higher fares. This really does not make a lot of sense.

Fares are really dictated by demand, and if we look at the leveraged carriers that are out there in the industry, we are well aware of Continental, Eastern, TWA and Pan Am. Those are the leveraged carriers. They are the ones that are most aggressive from a

pricing standpoint. So looking forward, I would not think that increased leverage in the industry will necessarily lead to higher fares and less competition. If anything, we might see more. We might see lower fares and more competition.

A third point, very importantly particularly with respect to the UAL transaction, where an ESOP, an employee stock ownership plan, is used as part of the financing of an LBO, that could lead to a revolutionary change in the labor-management relationship in the airline industry.

For instance, in the United transaction I believe part of their contract settlement with the pilots calls for a seven-year contract, which in itself is revolutionary, and it calls for no strike in that contract. That is a very significant development that could be duplicated elsewhere.

The result of this would be a less disruptive and strike-prone industry. It would result in greater productivity among workers and employees, and it would certainly enhance the competitiveness of the ESOPs, that is, and offset some of the higher debt burden with increased productivity and perhaps earnings.

Lastly, one thing that an LBO will not result in, in my opinion, is less safety. There is, as far as I can see as a financial analyst, no empirical evidence correlating the level of safety with the level of an airline's debt. There are accidents in the industry. They are unfortunate, and they occur; but they occur among large airlines, small airlines, leveraged airlines and unleveraged airlines. I have just not seen any empirical evidence, any data quantifying that relationship even though it is a very popular theory.

With respect to the equity investments in the airline industry by the foreign carriers, this is a tribute to the U.S. industry. It is a tribute to the relative successes of deregulation in the U.S. industry.

When KLM or British Airways wants to invest hundreds of millions of dollars in our airlines, albeit at premium prices, and not invest that capital in their own companies, which I would suggest is at relative discounts or relatively cheaply and they both trade publicly, it is a real tribute to their interest or to our deregulated industry.

Now why the increased interest by the foreign carriers? A couple points to wrap up the summary comment. The U.S. market is a world leader in the airline industry, and we certainly cannot let that leadership role slip. The U.S. industry is a leader in marketing, in information systems, fleet planning, schedule planning, maintenance, computer reservation systems, and it has been a leader in terms of dealing with the effects of deregulation.

Deregulation is sweeping the globe. We are seeing deregulation efforts in New Zealand, Australia, Mexico, Japan, Canada and, of course, in 1992 in Europe which they are labeling liberalization.

These foreign investments are an outcropping of the joint marketing relationships that have occurred in the industry: the code shares; the sharing of terminals. These have been very successful for both carriers, and that has led to the desire of foreign carriers to extend those benefits with some equity investment.

Secretary Skinner mentioned the return on investment. That is a very significant criteria in the interest that foreign carriers have.

The return on investment is superior here in the U.S. to their own investment in the U.K., Canada, wherever.

KLM was looking at getting a 14 percent piece of paper. In their transaction, British Airways is looking at 14 and 18 percent preferred stock. Those are clearly superior yields. With respect to my colleague, Mr. Beauvais, a panel member, Ansett of Australia owns a significant investment in America West, and they have had a very attractive return on that investment. So that is another reason for the interest on the foreign carriers.

Lastly, I want to point out that one of the reasons for this trend, all airlines but particularly in the U.S. with this perhaps excess of growth are extremely capital intensive. They need capital. They need access to all forms of capital, whether it be debt and/or equity. With capital, airlines can grow, they can hire people, they can expand their fleet, they can modernize their fleet. Without capital they simply cannot do any of that.

I would suggest, therefore, as we look at the legislation, S. 1277, we take into account the national security interest that Mr. Skinner mentioned that is so important and also the trade concerns, the bilateral negotiations on route awards and whatnot, the sensitivities there. I suggest these be addressed in the policy.

We should be careful not to restrict U.S. carriers access to capital, foreign or otherwise. I would suggest this because in part there may be a time in the future where a U.S. airline, taking Pan Am as an example, is faced with the prospect of going belly up or receiving a significant capital infusion from a foreign entity, 20 percent, 30 percent, 40 percent, if the U.S. capital markets have shut the door on Pan Am. I would note it is very difficult for Pan Am to raise capital here in the U.S. at this time.

I do not think we want to restrict that flexibility or limit that flexibility legislatively if that does happen in the future.

I would be happy to answer any questions on this, sir, and my formal testimony.

[The statement follows:]

STATEMENT OF TIMOTHY PETTEE, FIRST VICE PRESIDENT, AIRLINE INDUSTRY ANALYST, MERRILL LYNCH CAPITAL MARKETS

Mr. Chairman, members of the Committee, thank you for the opportunity to address you on the important issues and significant trends developing in our nation's airline industry.

There are important national aviation policy interests which need to be addressed amidst the current capitalization and competitive trends in the United States airline industry. The role civil airline fleets and facilities play in the national security of the United States should not be impinged. The ownership and control of these important assets by United States citizens and/or entities is vital to their utilization and effectiveness. Further, the changing nature of international airline competition amidst the increasing number of cross-border partnerships and alliances requires careful scrutiny and if necessary measured response to ensure the equitable balance of U.S. and foreign interests. And domestic competitive trends too need to be addressed to prohibit anticompetitive corporate policies by the nation's airlines.

However, the current trend toward the recapitalization of the airline industry, including significant leveraged transactions and the interest of several foreign carriers to invest in U.S. airlines, is compatible with U.S. national aviation policy interests, in my opinion.

The U.S. airline industry is among the most capital intensive of all U.S. industries. For example, the capital cost of the new Boeing 747-400 is in excess of $125 million, and in the markets in which it is designed to serve is a necessary competitive tool. Limiting access to capital markets, both equity and debt capital, could have a serious detrimental impact on the

financial strength and competitiveness of the U.S. airline industry.

Despite misguided (in our opinion) statements to the contrary, higher levels of debt and debt service do not translate into higher fares and less competitive pressures in an industry as competitive as the airlines today. Airline fares, which have grown less than the rate of inflation since deregulation, are dictated by demand. In the face of weak demand, airlines would likely not be able to raise fares, no matter what the level of debt and debt service. By way of evidence, the most leveraged carriers in the industry today, Continental, Eastern, Pan American and Trans World are the most aggressive fare cutters. Further, empirical evidence does not suggest there is a correlation between safety and levels of debt and debt service. The proper levels and mix of debt and equity capital should be left to the mechanisms of the capital marketplace, upon which the foundation of our economic system is built.

With respect to equity, the growing interest in foreign equity investments in U.S. airline companies is another example of the relative successes U.S. airline companies have recorded in the deregulated environment of the 80's. These cross border investments provide much needed capital to grow and enhance the relative competitiveness of the U.S. industry and those companies in which such investments are made.

Current federal legislation limits non-United States citizens and/or entities to 25% of the common stock of a United States airline. Yet recent policy initiatives have been interpreted to limit 25% of the equity capital--common and preferred stock--as

well as the board representation of non-United States citizens and/or entities.

From an accounting perspective, "control" is determined upon acquisition of a majority of the voting stock or representation of a majority or "significant influence" on the board of directors, neither of which has been attained in completed and pending foreign investment transactions in United States airlines. Without a majority of the voting stock, or majority representation on the board (without which "significant influence" is unlikely), it is unlikely any investor is in a position to "control" an entity and its corporate direction. While it is in the U.S. national policy interests to ensure the control of vital airline assets within the U.S., recent policy initiatives have instead served to limit U.S. carrier's access to much needed capital--and equity capital at that.

The current federal legislation concerning foreign ownership interests in U.S. air carriers and recent broad interpretations of it fall short of simultaneously allowing U.S. carriers the benefits of increased access to additional sources of foreign equity and debt capital without ceding control. The legislative effort that may be needed is one in which the parameters of just what constitutes control are more narrowly defined, perhaps to coincide with the accounting interpretation of the issue. Armed with that legislation, U.S. carriers can have increased and perhaps neccessary access to foreign equity and debt capital while the U.S. national aviation policy interests are represented.

EFFECT OF LEVERAGED BUYOUTS OR OTHER
ACQUISITIONS OF U.S. AIRLINES

Forecasting airline industry behavior is a difficult undertaking at best. However in assessing the likely effect of leveraged transactions in the airline industry, there is precedence of individual carrier leveraged transactions which aid the forecasting process. As such, the airline industry is not neccessarily moving into uncharted and unanalyzed territory. Trans World Airlines was acquired in a leveraged takeover in 1987. And currently Continental Airlines and Pan American World Airways are highly leveraged carriers the behavior of which also can aid in forecasting the effects of the leveraged transactions currently being undertaken in the industry.

Growth and Expansion Plans

The most significant byproduct of leveraged transactions in the airline industry is the possible curtailment, deferral and/or abandonment of significant growth and capital spending plans by the airline industry. After two years of relatively modest capacity growth (1989 flat, and 1988 5%), the airline industry in 1990 is expected to grow capacity by 8%. With the tremendous orders of new aircraft, nearly $40 billion last year alone, resulting in substantial numbers of deliveries in the 1991 - 1994 timeframe, capacity growth over the longer term is expected to be between 6% and 8%. Capital expenditures during this five year time period are expected to approximate $15 billion per year. Financing for these expenditures is expected to come from internally generated cash flow, debt and equity capital, and most importantly, via leasing capital. These

financing plans were laid with a certain forecasted capital structure, which likely did not include the acquisition of significant debt and other capital to finance the takeover of the carrier. Since sources of capital are not unlimited, it is conceivable the industry may opt to and/or be forced to forego certain capital spending and growth plans envisioned under a different capital structure.

Curtailment, deferral or abandonment of certain capital spending and growth plans would result in a slower rate of capacity growth for the U.S. airline industry. Importantly, it is not expected that current levels of service and investment would be impacted. However, the slowing in the rate of capital spending and capacity growth is in our opinion not neccessarily detrimental to the financial well being of the industry or the best interests of U.S. aviation policy. In the years after deregulation, the periods in which industry stability was the least was during periods when capacity growth was the most. In fact, the current 6% - 8% capacity growth forecast for the U.S. airline industry, is generally in excess of the 5% - 6% forecasted rate of traffic growth over the longer term, which would lead to lower operating efficiency (load factors) by the industry. Thus the market's slowing the U.S. industry's zest for growth to a level more in line with forecasted long term traffic levels could at the most have a positive influence on the U.S. industry and at the least would not result in a significant deterioration of the U.S. industry's competitiveness and/or market share globally.

Competitive Implications and Importance of Cash Flow

A second significant effect from leveraged transactions in

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the airline industry is the likely increased importance of and emphasis on operating cash flows to fund growth and finance debt service. The increased importance of cash flow in marketing and pricing arenas, would result in more, not less price competiveness in the U.S. industry. A popular misconception about airline leveraged buyouts is that airlines, straddled with more debt, would be more inclined to raise fares than lower them, even during seasonally and cyclically slow periods of traffic. The theory suggests prices would rise above where the market would otherwise be. While the entire U.S. industry appears more rational than in years past and is intent upon abandoning uneconomic competitive fare actions, this theory flies in the face of the market forces which continue to dominate the airline industry. We would therefore expect that demand, not the state of a carrier's balance sheet, will dictate airline pricing. In fact during periods or in markets of slack demand, airlines are more likely to price their product aggressively and competitively to cover cash operating costs, including debt service, than to raise fares and risk the loss of market share and cash flow.

Evidence of the effect on competitiveness amid leveraged air carriers can be seen in the pricing and competitive marketing of leveraged carriers Continental, Eastern, Pan American and Trans World. Each of these airlines has debt to capital ratios in excess of 100% (i.e. they have negative shareholders' equity). Are they able to raise fares above where the market rate would otherwise be? No. In fact, these carriers are more aggressive in pricing their products competitively than their less leveraged

major competitors. And the rate of increase in their average fares has been less than that of the industry as a whole.

Safety and Financial Fitness

The single most important common denominator and market incentive among airlines in the U.S. and around the world is the adherence to operating a safe and reliable air carrier. Without adherence to this principle, airlines would fail long before aggressive growth plans, excessive debt or management errors caught up to them. As there is no empirical evidence which correlates the degree of safety of a carrier and its level of debt and debt service, the increase in leveraged transactions is not expected to have an effect on the levels of safety in the airline industry. Unfortunately, accidents and mishaps do occur. However, such incidents have occurred among large, medium and small carriers and among carriers with strong financial conditions and with weak financial conditions.

With respect to the impact leveraged transactions might have on the financial fitness of a carrier, it is difficult to determine what constitutes a "financially unfit" airline. Operating conditions and balance sheets vary among airlines. The balance sheet and levels of debt service compatible with the operating environment of one air carrier may not be compatible with the balance sheet and operating environment of another. One of the largest airline companies in the industry employing more than 40,000 personnel and serving a global route network currently has more than $5.5 billion in long term liabilities and a deficit stockholders equity of nearly $600 million. Would it be in the best interests of U.S. aviation policy to declare

this entity financially unfit? Obviously not. While current levels of reporting guidelines and inspection are neccessary, no more efficient mechanism than the competitive and capital marketplace exists to determine the financial fitness of an air carrier.

EFFECT OF ACQUISITON OF INTERESTS BY FOREIGN AIRLINE OR INTERESTS IN U.S. AIRLINES

The growing interest among foreign airlines investing in U.S. carriers is indicative of the relative success U.S. carriers have enjoyed in recent years. The investment trends are an extension of the significant benefits realized by U.S. and foreign carriers in the many marketing alliances forged among carriers. Initially these alliances were structured around the successful frequent flyer programs operated by U.S. carriers. The alliances were further structured to align carriers schedules and pricing in an effort to capture and retain the flows of traffic between and among U.S. and foreign carriers. Investing in the capital stock of the marketing partner is a logical extension of the desire to see some return on the carriers efforts. While the foreign investments in U.S. airlines pose complex trade and national security concerns, the overiding effect of the investments is to increase the availability of capital neccessary for growth and as such enhances the competitiveness of U.S. carriers in the global marketplace.

Increased Availability of Capital

Airlines are extremely capital intensive. Typically sources of capital have included public and private debt and equity markets, leasing and internal cash flow. With the significant

increase in capital expenditures and capacity forecasted for the next five years, access to the broadest range of capital, including foreign equity capital, and the positive competitive implications brought with it, is highly recommended for nearly all major U.S. carriers.

Already, the investment by foreign carriers in U.S. carriers has had a substantial positive impact on certain U.S. carriers without compromising trade and national security issues. America West Airlines, the largest and one of the most successful of the post deregulation airlines, received a significant infusion of important equity capital in 1987 from Ansett Airlines of Australia. At the time of this investment, when America West was in the midst of a significant expansion of its operations, access to a comparable source of capital was not available to the company. The investment calmed liquidity and capitalization concerns at the carrier, enabling it to modify its growth plan with positive results in ensuing periods. In addition, Scandinavian Airlines System (SAS) provided needed capital to Texas Air Corporation as part of a transaction in which SAS purchased shares of Texas Air in the open market. While only a relatively small portion of new capital was realized by Texas Air, the agreement included significant operating and marketing alliances which have benefitted the companies airline entities.

Control Concerns

Despite the benefits of the equity investment relationships, there are significant trade and national security interests which need to be maintained if the U.S. airline industry is to maintain its position of relative strength in the global airline

marketplace. In the event of national emergency, the role civil airline fleets play should not be in a position to be compromised by foreign controlling interests. Further there are important trade concerns among the complex bilateral air service treaties in which the best interests of the United States would be represented by the absence of foreign controlling interests.

Current federal legislation limits non-United States citizens and/or entities to 25% of the voting stock of a United States air carrier. Yet recent policy initiatives by the Secretary of Transportation have been interpreted to limit 25% of the equity capital--common and preferred stock--as well as the board representation of non-United States citizens and/or entities, despite the acquisition of only a small portion of the voting stock and a significant minority of the board.

From an accounting perspective, "control" is determined upon a) acquisition of a majority of the voting stock of an entity, b) majority representation on the board of directors (even if the share of voting stock is less than 50%, or c) the ability to exert "significant influence" on the board of directors. Without the majority of the voting stock and/or majority representation of the board it is highly unlikely any party could exert "significant influence" on the board and the company's strategic direction. Thus from an accounting perspective, the NWA\Wings Holdings\KLM transaction did not appear to theaten the ability for U.S. citizens and/or entities from exercising control. As such it appears a substantial source of equity capital for NWA and the airline industry has been impinged, setting a dangerous precedent.

The current federal legislation concerning foreign ownership interests in U.S. air carriers and recent broad interpretations of it fall short of simultaneously allowing U.S. carriers the benefits accompanying additional equity capital investment without ceding control. The legislative effort that may be needed is one in which the parameters of just what constitutes control are more narrowly defined, perhaps to coincide with the accounting interpretation of the issue. Armed with that legislation, U.S. carriers can have increased and perhaps neccessary access to foreign equity and debt capital while U.S. national aviation policy interests are represented.

ORIGINS OF THE RECAPITALIZATION TREND IN THE AIRLINE INDUSTRY

Beginning with the privatization of Trans World Airlines in 1988 and continuing more recently with the completed privatization of NWA Inc., parent of Northwest Airlines and the contemplated going private transaction approved by the Board of Directors of UAL Corporation, parent of United Airlines, the United States airline industry is undergoing the most significant of several evolutionary changes since the deregulation of the industry in 1978.

The first significant change after deregulation was the period from 1981 to 1985 which saw the start up of many "new entrant" airlines. Lack of adequate capital, a sharp recession and poor management (to a name a few reasons) led to the demise of most of the new entrant post deregulation carriers. The second major phase in the industry post deregulation, from 1985 to 1988, was the consolidation phase, in which mostly well capitalized major airlines acquired other carriers. Coupled with the demise of many new entrant airlines, the number of U.S. carriers declined. The third major phase in the industry, the period from mid 1987 to mid 1989, may be characterized as the prosperity phase, in which industry earnings reached record levels. While some may attribute this phase to the consolidation of the industry, the strong underlying economic environment, in my opinion, contributed more to the level of earnings (as discussed below) than any other factor.

The current trend toward privatization in the airline industry, accomplished via leveraged transactions, is leading to

a recapitalization of the U.S. airline sector. This recapitalization trend is attributable, in part, to the following three factors.

1) The belief that the significant earnings and earnings potential demonstrated during the last two years, and the concurrent strong level of cash flow generation is sustainable. Inherent in this tenent is the expectation that the degree of cyclicality and even seasonality airline earnings and cash flow have historically demonstrated will be absent or lessened in the future.

2) The realization of premium values for used aircraft, facilities as well as new aircraft delivery positions, which has increased the liquidity (and enhanced the equity capital) of many carriers. Included in the strong market for airline assets is premium values being accorded gates, slots, real estate and other tangible and intangible assets.

3) The availability of capital, both equity and debt, due in part to the renewed interest in airline lending by commercial banks and the current favorable interest rate environment. Included in this tenent is the tremendous increase in leasing capital, which has provided, and is expected to continue to provide more than half the capital expenditures in the 1990s.

SUSTAINABLE (?) EARNINGS

Recent Earnings Trends

The two year period ended June 30, 1989 were the most prosperous ever recorded in the airline industry. Operating earnings of the major airlines, which account for more than 90% of the U.S. industry's traffic, rose by 10% in the second half of 1987 compared with the same year earlier period. For 1988, industry revenues grew 11% and operating earnings by 28%. Traffic, revenue passenger miles, increased a modest 5% for the year. However the 5% unit growth was accomplished amidst a 7% advance in the average fare, or yield per passenger mile.

Contributing to the strong revenue performance was the strength in the general economy in 1988, a year in which real GNP grew more than 4%. However the strength in revenue performance in 1988 was aided by 9% growth in international traffic recorded by U.S. major airlines, compared with a 4% increase in domestic volume. The industry reigned in capacity growth in 1988 to 4% versus the 7 - 9% rates of growth experienced in the mid 1980s. Operating expenses, aided by flat fuel costs, rose just 10%, helping U.S. majors post operating earnings of $2.3 billion in 1988, up 28% from the $1.8 billion posted in 1987. Operating margins recorded by the industry rose to 5%. The strength in the industry performance in 1988 surprised many observers, producing high expectations for earnings performance in 1989. Optimism was in part kindled by the mid November restructuring of discount fares. This restructuring, essentially the elimination of many low end, "junk fares" came just prior to the seasonally strong holiday traffic period, and led to a significant rise in fourth quarter passenger mile yields.

The first half of 1989, the period during which the trend toward recapitalization of the airline industry became evident, saw the continuation of record revenues and earnings in the airline industry. Boosted by the late 1988 fare restructurings, and a still strong economic environment, the average fare rose 11% in the first quarter of the year, compared with the year before, and second quarter yields were up 6%. The average yield in the month of March alone rose by 17%, year to year. Despite softening traffic trends, particularly in domestic markets, industry revenue growth in the first half of this year was 8%.

Capacity growth for the industry in the first half fell about 1% (due in part to the bankruptcy filing and curtailment in services by Eastern Airlines) and costs, with fuel costs receding from early 1989 highs, rose just 4%. As a result, operating earnings have risen a strong 22% through the first six months of this year compared with the strong first half of 1988.

The Near Term Outlook for Airline Earnings

Ironically, recent indications suggest the period in which the takeover of airline stocks reached frenzied proportions and during which the recapitalization of the airline industry became evident, may have been the peak of the current earnings cycle. While forecasting airline industry results is somewhere between an inexact science and a lost art, at the least, the outlook for the near term (second half of 1989 and the year 1990) does not call for the continued earnings momentum the industry has recorded over the past 18-24 months.

Earnings expectations for the second half of 1989 have recently been revised downward by many airlines and industry forecasters. At the heart of these downwardly revised expectations are signs the sluggish domestic traffic trends recorded all year are due to the rate at which fares have risen--evidence industry elasticity of demand has not been materially altered by the consolidation and relative concentration of the industry. Sluggish demand coupled with stubborn or absent increases in the average fare is expected to produce second half revenue growth of just 4%. Capacity

additions are expected to quicken in the second half of the year helping push the increase in operating expenses to 7%. The result is expected to be operating earnings of $1.0 billion, down 31% from the $1.4 billion posted in the second half of last year.

The Merrill Lynch Capital Markets Equity Research preliminary industry forecast for 1990 calls for a 27% decline in operating earnings. Our forecast, predicated upon modest real economic growth, is most affected by an expected sharp increase in the rate of capacity growth, to 8.2% from essentially flat capacity growth in 1989 versus 1988. With unit operating costs--cost per seat mile--conservatively forecasted to rise at least 3%, total operating expenses would thus show 11% growth for the year. We think the combination of traffic (forecasted to rise 6.5%) and yields (up 3%) is unlikely to outpace the rate of expenditure growth producing the decline in operating earnings noted above. Operating earnings are nonetheless expected to reach $1.6 billion for the year.

The Longer Term Outlook for Industry Earnings

While a decline in industry earnings in 1990 may cause some cause for concern among airline investors, and placate critics of the recapitalization trend in the industry, the drop is not expected to jeopardize the level of financial health and stability the industry has achieved in recent years. Over the longer term--into the 1990s--the industry is expected to show significant further improvements in operating economics (attributable to the acquisition of new airliners and phasing out of older equipment). In addition, a byproduct of the

recapitalization of the industry--the Employee Stock Ownership Plan--and employee ownership in general is expected to lead to enhanced employee productivity. Furthermore, advances in information systems in the 1980s should lead to incremental benefits and economics in the distribution of airline tickets. Thus over the longer term, airline industry earnings are expected to remain at healthy, albeit during periods of reduced economic activity perhaps not at improved levels. But armed with improvements in the above noted operating areas, the industry amidst an improving economic environment is expected to be well poised to challenge the record level of earnings recorded in 1988.

REALIZATION OF ASSET VALUES

Aircraft, New and Used

A second major catalyst in the recapitalization trend in the airline industry has been the demand for aircraft. Used aircraft values have been steadily rising, despite concerns and increased costs of aging aircraft fleets. Most carriers are taking advantage of this demand by selling into the strength of the market, raising significant degrees of liquidity and with the accompanying accounting gains, strengthening the equity capital of the company. The demand for used aircraft has in part been created by strong underlying traffic demand worldwide, and insufficient new aircraft production schedules and delays in production of certain aircraft types. Used equipment in many cases is being acquired on a short term basis as a stop-gap measure to bridge growth plans until new aircraft are delivered.

Indicative of the strength in pricing of used aircraft is a recent purchase of four 13 year old B747-200 aircraft by a U.S. national airline from a major foreign carrier for $41 million per aircraft. When the aircraft were first put on the market in mid 1988 by the foreign carrier the aircraft were thought to be worth $28 million.

The most significant factor driving the value of used aircraft currently has been the demand by leasing entities to purchase used and new aircraft equipment for lease to major and other carriers. Many carriers are selling large portions of their existing owned operating fleets and leasing them back for varying periods of time. Contributing to this phenomenon has been the strong economic fundamentals underlying the leasing industry. For the airline the potentially higher operating costs incurred via leasing are offset by the increased flexibility and sharing of asset risk leases offer. For the leasing company the strong underlying margins in the current interest rate environment coupled with the tax advantages a leasing portfolio portends offset the equipment residual value risk they undertake.

The value of new aircraft delivery positions, or aircraft futures, has also contributed to the enhanced liquidity and valuation accorded airline companies. Again due to strong demand, the value of new-as-yet-manufactured-but-ordered aircraft has been increasing. Coupled with the volume discounts most major carriers are able to achieve (and which are typically not disclosed by the manufacturer or the airline), the future delivery position or option has significant value--to other

airline and to the manufacturer. In this respect, the market for new aircraft is not unlike the reported market for the Mazda Miata sports car. While listing for approximately $15,000 but in short supply, dealers are taking orders for the car significantly in excess of list price. A second-tier market has even developed for those above-list price orders, with some orders for the car bid at as high as $24,000. Evidence of this trend in aircraft finance can be seen in the sale in December 1988 by Pan Am of delivery positions for up to 50 Airbus Industrie A320 aircraft for $115 million.

The significance of the strength in aircraft values is two fold: sale and leaseback of the equipment at premium prices affords the carrier increased liquidity and equity capital without significantly increasing costs and compromising growth plans. Further, these values and/or enhanced liquidity can be useful in obtaining and/or securing leveraged acquisition debt as part of a going private transaction.

Non Aircraft Asset Values

Further contributing to the recapitalization of the industry has been the significant rise in value of non aircraft assets, including gates, slots, airport facilities, real estate and perceived values in international route authorities. With the absence of any major new airport construction in the 1980s, the value of existing airport facilities has skyrocketed. These values for gate space, ticket counter footage and operations are the largest barrier to entry in the industry today. Carriers which have launched significant new hub operations at existing airports have expended an estimated $250 - $400 million for

facilities and other assets, exclusive of new aircraft. Acquisition of lesser facilties are estimated to result in even higher unit acquisition costs. Most major carriers have long since depreciated major airport facilities acquired 20 and 30 years ago. Thus these facilities are in some cases important sources of debt capital via remortgaging and/or sale/leaseback transactions.

With respect to intangibles such as airport departure and arrival slots and international route authorities, legislative and policy initiatives have been taken to discourage the windfall profits attributable to these essentially government allocated assets. That however has not diminished the underlying value, i.e. cash flow, attributable to these increasingly scarce resources. Recently, in what might portend a trend, a major U.S. airline sold debt in part secured by the increased value of its airport departure and takeoff slots.

AVAILABILITY OF CAPITAL

Debt

A result of the earnings and asset value trends in the airline industry has been renewed and substantial interest on the part of commercial banks to provide debt capital, primarily secured, to U.S. airline companies. Syndicates for the debt portion of the leveraged transactions completed and contemplated in the airline industry today have reportedly been substantially oversubscribed. Thus there is more capital available than deals, leading to the conclusion transactions involving other U.S. carriers could emerge.

Underlying the demand for this capital is the current and expected future favorable interest rate environment in U.S. capital markets. However, as importantly, is the strong financial condition the airline industry has developed in recent years. In the years immediately after deregulation, the industry as a whole was highly leveraged, with debt to total capital of approximately 60%. With the strong level of earnings since 1984 adding to equity, and the more recent preponderance of leasing keeping debt off the balance sheets, the debt to total capital ratio of the U.S. airline industry has declined to 44%, which includes the excessive debt to capital ratios of Continental, Eastern, Pan Am and TWA.

Equity

At the heart of the controversy concerning the recapitalization of the industry has been the interest of foreign carriers to invest in U.S. airlines. While a new trend in the airline industry, the practice is not new to the transportation sector. Canadian interests have for a time held significant investments in U.S. trucking and railroad concerns. However, the interest of foreign carriers investing in the U.S. and of U.S. carriers investing in foreign carriers is part of the globalization of the airline industry spurred in part by the successful deregulation of the U.S. industry and subsequent deregulation efforts around the world (including Australia, Canada, Japan, Mexico, New Zealand and coming in 1992, Europe).

A fast emerging trend in the airline industry is the use of Employee Stock Ownership Plans as a source of equity capital in leveraged transactions. The significant tax advantages of such ESOPs created by Congress in past sessions have only recently been applied in the airline industry, despite successes of several carriers in which employess have significant equity stakes.

Senator FORD. Thank you very much.
Mr. Beauvais.

STATEMENT OF EDWARD R. BEAUVAIS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AMERICA WEST AIRLINES, INC.

Mr. BEAUVAIS. Thank you, Mr. Chairman and Senator McCain. I am Ed Beauvais, Chairman and Chief Executive Officer of America West Airlines. This subcommittee is to be commended for conducting this hearing on the subject of foreign investment in U.S. air carriers.

As is explained in greater detail in my testimony, 20 percent of America West common stock is owned by Transpacific Enterprises, Incorporated, a subsidiary of Ansett Transportations Limited, which among other things operates an Australian airline, Ansett Airlines of Australia, and owns a substantial interest in an airline operating in New Zealand.

Prior to the consummation of that transaction, we met with DOT representatives to discuss whether the proposed sale of stock would have any effect on America West's "citizenship". We also filed a 45-day notice relating to possible competitive effects of the transaction. By Order 87831, the Department determined that the proposed purchase could proceed under section 408 of the Act because it found that the purchase did not present competitive and public interest issues that warranted examination in section 408.

Additionally, the Department determined that America West continued to be a citizen of the United States within the meaning of section 101(16) of the Act. This citizenship determination was just reaffirmed by the Department in the order released Monday in the U.S.-Australia service proceeding.

America West has been extremely concerned about the increased level of concentration in the domestic airline industry today, concentration that has come about largely as a result of the mergers and acquisitions approved by the Department of Transportation during a period when the DOT had all but effectively abandoned its jurisdiction over such transactions.

While it may in one sense be too late to undo many of what we believe were misguided policy decisions during the 1985 to 1988 period by the Department, we applaud the efforts of Secretary Skinner to scrutinize two recent transactions, KLM's investment in Northwest and British Airways' investment in United, each of which raises important questions concerning concentration in international air transportation.

We also support the steps that have been agreed to by the Secretary and Wings holding Northwest. Although there are those who may criticize Secretary Skinner for taking these steps, it is important to remember that: number one, international air transportation, unlike many other international markets, is regulated by its own set of governing principles; and number two, competitive opportunities are limited as a consequence of bilateral provisions that restrict competition.

It is particularly appropriate, therefore, for the Department of Transportation to carefully evaluate control issues, especially when that control may be exercised by an actual or potential competitor

of the U.S. air carrier as is the case with KLM-Northwest and British Airways-United.

Insofar as S. 1277 is concerned, DOT previously had the opportunity to evaluate competitive fitness, citizenship and route transfer issues related to each proposed acquisition before the transaction became effective because of the then applicable prior approval requirements of section 408 of the Act.

With the transfer of antitrust responsibility to the Justice Department, DOT is now limited to reviewing such transactions under its fitness, citizenship and route transfer authority, none of which provides specific statutory authority requiring that transaction involving these issues to be evaluated by DOT prior to their consummation.

Consequently, grant of such prior approval authority to the Secretary as is provided in section 2 of S. 1277 would assure that the Secretary is not forced to address transactions after they have been consummated, as was the case with KLM's acquisition of interest in Northwest which, pursuant to the consent order, must now be unwound.

We would also point out that the definition of controlling interest in the bill—that is, direct or indirect ownership of 25 percent or more of the voting stock of such air carrier—is a less encompassing definition of the term than is used presently by the DOT in evaluating control issues under section 101(16) of the Federal Aviation Act.

Consequently, we would urge that the definition of controlling interest be revised so as to incorporate DOT's position that a U.S. carrier must, in fact, be controlled by U.S. citizens.

Finally, the subcommittee may wish to consider including a consultative role for the Secretary of Transportation in the Justice Department's evaluation of such transactions under the Hart-Scott-Rodino Act.

As you know, Secretary Skinner has written letters to the Justice Department on at least two recent proposed transactions, the American-Delta-CRS partnership and USAir's purchase of Eastern's assets at Philadelphia, expressing concerns with respect to those transactions. It may be advisable to include a specific statutory role for the Secretary of Transportation in such matters, particularly those with international implications.

We appreciate the opportunity to appear before you today and would be pleased to answer any questions.

I have one comment on Mr. Pettee's remarks that I would like to make about Pan American. When the first energy crisis hit in 1973, there was a lot of discussion and serious consideration given to the sale of Pan American at that time to the Shah of Iran.

Now you can just imagine what we would be dealing with today if that transaction had gone through. So in our opinion, these are very important issues with which we are dealing today and have to be reviewed very carefully, as you have indicated. We certainly appreciate the opportunity to be here today.

[The statement follows:]

STATEMENT OF EDWARD R. BEAUVAIS, CHAIRMAN AND CEO, AMERICA WEST AIRLINES, INC.

Mr. Chairman and Members of the Subcommittee, I am Edward R. Beauvais, Chairman and Chief Executive Officer of America West Airlines, Inc., a post-deregulation airline that began operations a little over six years ago. The Subcommittee is to be commended for conducting this important hearing, and we very much appreciate the opportunity to testify on the subject of foreign investment in United States air carriers.

Background of America West Airlines, Inc.

By way of background, America West is one of the few remaining post-deregulation carriers. We began operations as a new entrant airline in August 1983 with three Boeing 737-200 aircraft operating to and from our Phoenix hub and the cities of Los Angeles, Kansas City, Colorado Springs and Wichita.

Since that time, we have grown dramatically. America West now operates a fleet of 79 aircraft: 64 Boeing 737s, eight Boeing 757s, and seven deHavilland Dash 8s. The number of cities we serve has increased from three to fifty. These America West operations extend across the United States and into Canada. On November 16, 1989, America West will further expand its national presence with the inauguration of Boeing 747 service to Honolulu from both our hubs in Phoenix and Las Vegas.

This phenomenal growth has brought America West to the point where we now provide service to more than 13 million customers annually. In the process of expanding our operation, we have created more than 10,000 jobs held by people who own stock in our company and participate in our employee profit-sharing plan.

As you may already be aware, twenty-percent of America West's common stock is owned by Transpacific Enterprises, Inc. (Transpacific), which stock was acquired in 1987. Transpacific is a U.S. corporation that conducts an aircraft leasing business in the United States and is a subsidiary of Ansett Transportation Industries Limited ("ATI"), an Australian corporation. Two corporations -- The News Corporation Limited ("News") and TNT Limited ("TNT") -- each own half of ATI's common stock. Another subsidiary of ATI, Ansett Transport Industries

(Operations) PTY Limited, operates an Australian airline, Ansett Airlines of Australia, and owns a substantial interest in an airline operating in New Zealand, but neither of these airlines provides service to the United States. TNT is a worldwide surface transportation company whose affiliates include United States trucking companies.

In accordance with the regulatory requirements that were in place at that time, representatives of America West and Transpacific met with D.O.T. representatives prior to the consummation of the transaction to discuss whether the proposed sale of stock would have any effect on America West's "citizenship" as that term is defined in Section 101(16) of the Federal Aviation Act of 1958, as amended. In addition, America West and Transpacific filed a 45-day notice under Section 303.57 of the Department's regulations relating to possible competitive effects of the transaction (which, under the regulations, was exempt from the prior approval requirements of the then-applicable Section 408 of the Act), and a request for a waiver of the full 45-day period so that the transaction could be consummated more quickly.

By Order 87-8-31 (copy attached), the Department determined that the proposed purchase could proceed under Section 408 of the Act, because the Department found, after analyzing the transaction, that it did not present

competitive and public interest issues that warranted examination in a Section 408 proceeding. Additionally, the Department determined, after evaluating the information provided by Transpacific and America West, that America West continued to be a "citizen of the United States" within the meaning of section 101(16) of the Act. This citizenship determination was just reaffirmed by the Department in an order released yesterday in the U.S.-Australia Service Proceeding, Order 89-10-2.

I might add that, in order to assure that foreign citizens could not assume control of America West, we amended our certificate of incorporation and bylaws so as to create a "foreign stock record," where non-U.S. citizen owners of America West stock are registered. The number of shares so registered is limited to 25-percent of the voting stock in America West, and, if at any time the number of shares known to be controlled by non-citizens exceeds 25-percent, the voting rights of stock owned by non-citizens that is not registered on the foreign stock record are suspended.

Industry Concentration And Foreign Investment In U.S. Air Carriers

America West has been extremely concerned about the increased level of concentration in the domestic

airline industry today, concentration that has come about largely as a result of the mergers and acquisitions approved by the Department of Transportation during the period 1985 through 1988, when the D.O.T. had all but effectively abandoned jurisdiction over such transactions. Indeed, as may be seen from the attached tables that were published in the Aviation Daily on September 22, 1989, the six largest U.S. carriers, American, United, Delta, Northwest, Continental and TWA, accounted for 75.73% of the system revenue passenger miles and 74.95% of the available seat miles in the first eight months of 1989 compared to 71.07% and 70.26%, respectively, for the same period in 1988.

We are aware that the members of this Subcommittee, the General Accounting Office and the Department of Transportation are presently studying the consequences of such concentration upon competition and, more importantly, the traveling public, and we fully support those efforts.

While it may, in one sense, be "too late" to undo many of what, we at America West believe, were misguided policy decisions that were made during the 1985-88 period by the Department, we applaud the efforts of Secretary Skinner to scrutinize two recent transactions, KLM's investment in Northwest and British Airways' investment in United, each of which raises important questions concern-

ing concentration in international air transportation. In that regard, we are supportive of the steps that have been agreed to by the Secretary and Wings Holdings. Thus, KLM's share of Wings' equity will be significantly reduced, KLM's right to appoint a financial advisory committee will be terminated, and KLM's representation on Wings' board will be significantly restricted with respect to access to information and involvement in competitively sensitive matters being considered by Northwest, to the end that KLM will not be in actual control of Northwest. Order 89-9-51 (copy attached).

Although there are those that may criticize Secretary Skinner for taking these steps, it is important to remember that international air transportation, unlike many other international markets, is regulated by its own set of governing principles and that competitive opportunities are limited as a consequence of provisions in bilateral agreements that restrict competition. Therefore, it is particularly appropriate for the Department of Transportation to carefully evaluate control issues, especially when that control may be exercised by an actual or potential competitor of a U.S. air carrier, as was the case with KLM and Northwest. For many of these same reasons, we urge the Department to scrutinize carefully the involvement by British Airways in United. Once again,

these carriers are actual and potential competitors, and great care must be exercised to evaluate the competitive effects of any control relationships that could exist, particularly in light of the existing marketing agreement between British Airways and United.

Specific Comments on S.1277

Prior to the transfer of responsibility for mergers and acquisitions from the Justice Department to the Department of Transportation, D.O.T. had the opportunity to evaluate the competitive, fitness, citizenship, and route transfer issues related to each proposed acquisition before the transaction became effective because of the then-applicable prior approval requirements of Section 408 of the Act. With the transfer of the antitrust responsibility to the Justice Department and the consequent loss of its ability to review transactions prior to consummation, D.O.T. is now limited to reviewing such transactions under its fitness, citizenship, and route transfer authority, none of which provides specific statutory authority requiring that transactions involving these issues be evaluated by D.O.T. prior to their consummation. Consequently, grant of such prior approval authority to the Secretary as is provided in Section 2 of S. 1277 would assure that the Secretary does not need to

address transactions after they have been consummated as was the case with KLM's acquisition of an interest in Northwest, which, pursuant to the consent order, must now be "unwound".

We would also point out that the definition of "controlling interest" in the bill, i.e., direct or indirect ownership of 25-percent or more of the voting stock of such air carrier, is a less encompassing definition of the term than is used presently by the D.O.T. in evaluating control issues under Section 101(16) of the Federal Aviation Act. As pointed out in Order 89-9-51, D.O.T. precedent with regard to citizenship requires ". . . that a carrier (and its parent company) in fact be under the actual control of U.S. citizens," Order 89-9-51 at 4, and D.O.T.'s inquiry focuses upon ". . . whether a foreign interest may be in a position to exercise actual control over the airline, i.e., whether it will have a substantial ability to influence the carrier's activities." Id. at 5. Consequently, we would urge that the definition of "controlling interest" be revised so as to incorporate D.O.T.'s position that a U.S. carrier must be controlled "in fact" by U.S. citizens.

Finally, the Subcommittee may wish to consider including a consultative role for the Secretary of Transportation in the Justice Department's evaluation of

such transactions under the Hart-Scott-Rodino Act. As you know, Secretary Skinner has written letters to the Justice Department on two recent proposed transactions, the American/Delta CRS partnership and USAir's purchase of Eastern assets at Philadelphia, espressing concerns with respect to those transactions, and it may be advisable to include a specific statutory role for the Secretary of Transportation in such matters, particularly those with international implications.

In summary, while enactment of this legislation was not necessary to permit Secretary Skinner to act in the case of KLM's investment in Northwest, it is important to note that (1) it was necessary for the Secretary to "unwind" this transaction after it was consummated, and (2) perhaps more importantly, Secretary Skinner, unlike his recent predecessors, has demonstrated a willingness to become involved in these important competitive and public interest issues. This legislation would ensure that his successors continue to be so involved. Consequently, we would urge that the Subcommittee adopt this legislation including our suggestions for a revised definition of "controlling interest".

Mr. Chairman, we appreciate this opportunity to testify on this important matter today, and I will be pleased to respond to any questions that you or the other members of the Subcommittee might have.

Senator FORD. Mr. Beauvais, I do not know what would have happened. Could we have taken it back?

You do make an excellent point.

Let me ask you, Mr. Pettee. You say that Pan Am and Eastern and all the others that have problems are more aggressive. Would there be anything in the old statement they lose dollars on every ticket and depend on volume to get by?

Mr. PETTEE. I am sorry?

Senator FORD. Do you raise money on every ticket and depend on volume to get by?

Mr. PETTEE. Ed may be able to address some of the pricing.

Senator FORD. You are the one who brought it up. I thought you might be able to clear this country boy's mind.

Mr. PETTEE. Right. Some airlines price to cover their cash costs, which would suggest that they are not making money. That does occur from time to time. An airline would stay in a certain market, maintain the presence in market, and just price to cover their cash costs.

Sure, there may be some people internally who would suggest that they are going to make it up on volume. We see this practice somewhat among the more leveraged carriers. It is irrational, but if they are generating cash to cover cash costs, including debt service, the incentive, albeit a somewhat misguided incentive, is still there to operate the service.

Senator FORD. You made a statement, at least I think I remember it correctly, that cutting maintenance was not one of your fears or not one of the LBO fears that we should have. If you are selling tickets just to cover your cash outlay and your debt service and that sort of thing, however, Braniff made a mistake. Whatever their judgment was, it did not come about, and they could not make their payment.

Say you are just skimming along, just barely getting by. Is there any concern in your mind that under the circumstances and the way things are evolving that there could be a cutback on maintenance in order to release the cash flow, thus jeopardizing the consumer?

Mr. PETTEE. Truly, Senator, I do not have those concerns. There is no greater incentive for an airline than to maintain a safe and reliable fleet. That is the greatest incentive they have. In talking to every carrier worldwide that has ever discussed it, that is the number one primary objective before earnings, before anything else. Maintain a safe, reliable, credible fleet, because if you do not have it, nobody is going to show up.

I think that, again, without that, the airlines would fail long before excessive debt or poor management decisions or excessive growth put an airline under.

Senator FORD. When you are talking about growth and you refer to the future and that sort of thing, are you depending on FAA's projections?

Mr. PETTEE. The 5 percent long-term growth projection? I have looked at that. I do depend upon that. The aircraft manufacturers, Boeing, McDonnell Douglas, Airbus, also put out a little bit more aggressive traffic forecasts. The long-term traffic forecast range is anywhere from 5 to 6 percent between now and 2000.

Senator FORD. Are you going on FAA's history in the last 10 years on their estimate of growth?

Mr. PETTEE. In some cases, yes.

Senator FORD. Let me just say they have been wrong for ten years. Let us hope that you do not bet you future on FAA's projection of the traffic growth.

Mr. PETTEE. No, I would not, Senator.

Senator FORD. If investment in airline companies is such a good idea, why are our carriers not seeking to invest in and buy out foreign carriers, or are we prohibited from doing that in other countries?

Mr. PETTEE. As far as I know, Senator, there is a myriad of laws and regulations and are restrictive that pertain to individual countries. There is, however, some investment going on. For instance, Delta owns now, I believe, 5 percent of Swiss Air.

Senator FORD. They own 5 percent of Delta.

Mr. PETTEE. That is correct.

By and large, it is my impression from talking to U.S. airlines that such investments have been discouraged, whether by statute in the country in question or just in practice. They have been discouraged.

Senator FORD. Would you in your financial background agree with some who argue that foreign airlines are seeking to reap the benefits of U.S. deregulation while offering nothing in return for their regulated industry?

Mr. PETTEE. I would not disagree with that.

I would also note, Senator, that relative to other portions of the world, the U.S. industry is, I think, far more attractive with the possible exception of the Pacific Rim, where the long-term growth forecasts of the FAA or aircraft manufacturers are clearly in excess of the system averages.

I do not think the U.S. carriers are really looking to invest heavily in Europe, for example, as Europe deregulates or liberalizes because there will certainly be some fallout that will occur in the early 1990s, perhaps resulting in some poorer returns on investment in Europe relative to the U.S. where we have already gone through the deregulation experience and the return on investment is a little bit better.

Senator FORD. Let me give you this case. It is typical because it is laying right out there in front of us. You are the investment company that put the arrangement together; i.e., Northwest.

Mr. PETTEE. You mean theoretically?

Senator FORD. Theoretically, yes.

Then after the fact, after the arrangement is put together, the U.S. Government steps in not with statutory provisions that would say that you have to restructure it, but the hammer is whether they yank their certificate or not. So your arrangement falls on its face.

Say KLM backs out now, and I guess that other people would come up with other money to make it whole, and maybe some American money would come forward to make it whole. Would that disturb you some if you had put it all together and we jumped in after the fact and, as we say, queered the deal?

Mr. PETTEE. Absolutely, Senator, although my firm was not involved.

Senator FORD. I know that.

Would it give you pause for consideration, concern?

Mr. PETTEE. Certainly. There were certainly significant expenditures that were made, time, money and otherwise, in putting the transaction together that probably is in the millions of dollars that might be classified as wasted efforts at this point.

So I would have that concern and would prefer that authority to be prior to the confirmation of the transaction, rather than after.

Senator FORD. Well, it is your statement or your prediction that operating earnings will begin to decline in 1990, is that correct?

Mr. PETTEE. That is correct.

Senator FORD. Mr. Beauvais, do you agree with Secretary Skinner and your friend to your right there that leveraged companies operate more efficiently to generate additional cash flow?

Mr. BEAUVAIS. No, I do not agree with that at all. I do not think there is any evidence to support the fact that a highly leveraged company is more aggressive in pricing its product compared to other carriers. One of the most aggressive carriers in our industry is Southwest Airlines, and they are one of the least leveraged airlines, so I do not think leverage and pricing are related at all.

I think pricing is a matter of the market niche and what carriers are doing to conduct a successful operation, and if you are highly leveraged you have a handicap in dealing with that kind of an environment rather than a beneficial condition.

Senator FORD. Let me ask this, then, should transactions or arrangements between two carriers with many of the same routes, or traveling the same routes be prohibited?

Mr. BEAUVAIS. Well, it is hard for me to answer that yes or no, but I think that is a very important consideration that has to be made in determining whether or not a transaction such as the KLM Northwest and/or United/British Airways transaction should be approved, because they are actual and/or significantly potential competitors.

We have foreign ownership at America West with Ansett airlines, but they are a domestic Australian carrier. There is absolutely no competitive implications in our relationship, so our relationship with respect to the foreign investment that we have has none of the ingredients that KLM/Northwest or United/British Airways has.

Senator FORD. I see, of course, the up-front cash, which now is being changed, leads to the possibility of the cancellation of contracts for construction of airlines from one company to another that the purchaser with 68 percent up-front cash would like to have. That has apparently been done.

The combining of aircraft and computer operations and travel agencies and all of that begins to bring it all in between the little white lines, as we say. It follows that we are not involved in their profits overseas but they are certainly involved in our profits here. With an unregulated or deregulated industry here and a regulated industry there, it seems that they are getting the best of both worlds at our expense.

On top of that, borrowing money from the Japanese and from Europe, that we go right back to our major competitors now and they are loaning the money to come over here and be involved more in taking over what has been ours. Maybe we ought to just open up the door and say, here we are boys, come in and buy us out, because you are using our money to buy us out.

Mr. BEAUVAIS. Well, the points you make are valid in my opinion.

The issue of major competitive confrontations being diminished by foreign carrier ownership interest in U.S. carriers is a very important part of the equation.

The others, of course, are also: the CRS combination, route realignments and market co-chairing arrangements, things like that, are very important because international routes are regulated and the domestic system is deregulated, and it is an important step that must be addressed right now.

That is why I think it is important for this legislation to prescribe to Secretary Skinner to get involved before a transaction is actually worked out.

But there is one other point that I do disagree with Mr. Pettee on, and I think it is very important. United does not have an issue facing it where it cannot raise equity capital. They are not faced with a shortage of capital. They can raise as much equity as they want without resorting to the transaction at stake here.

Northwest was not faced with an issue of shortage of capital. They are a very strong company that can raise as much equity capital as they wanted. Delta is not faced with that issue, nor is U.S. Air. So we are not looking at a last resort condition for our industry to go to foreign carriers to make that investment. It is not that case at all.

Senator FORD. Senator McCain.

Senator MCCAIN. Thank you, Mr. Chairman. Mr. Pettee, from the point of view of the capital markets, what would be the problem with the Secretary having prior review authority such as is called for in legislation that Senator Ford and I have proposed, S. 1277?

Mr. PETTEE. I do not think there would be a problem with the prior approval aspect. I think it would be welcome.

From the point of view of the capital markets, Secretary Skinner noted the concerns would be maintaining the free flow of capital debt or equity without jeopardizing the significant security, trade and competitive issues that confront the industry.

Again, I think the marketplace bankers would welcome the prior approval issue.

Senator MCCAIN. If I understand your statement, written and verbal, we should not be concerned if every major airline in America is the subject of an LBO?

Mr. PETTEE. Well, I do not want to suggest that I would endorse, or the capital markets would endorse, the complete leveraging of the airline industry.

Senator MCCAIN. Is that not apparently what is happening?

Mr. PETTEE. Not necessarily. You know, we are seeing a couple of significant transactions without those. We do already have a somewhat leveraged industry with the three or four carriers I noted in

the testimony. Yes, the debt to equity ratio of the airline industry is increasing, and will increase significantly as a result of the UAL transaction and the NWA transaction——

Senator MCCAIN. And rumors in the market about possible takeover of American, given the way its stock moved up. Is that correct?

Mr. PETTEE. Yes, there are significant rumors and speculation about American. They come up on Delta. They come up on America West. No airline—no publicly-traded airline is free from the speculation or the rumors.

Senator MCCAIN. I guess your answer is, it is of concern, but not major concern?

Mr. PETTEE. Well, the industry would clearly rather not pursue these transactions. The capital plans that were put in place, in my understanding, at Northwest and at United, did not include taking on an extra $3, $4, $7 billion in debt. The managements there clearly did not choose this particular course of action. The capital markets, some of the aspects of the capital markets forced this issue upon them.

With respect to pricing, as a point in my prepared testimony and my remarks, I was merely trying to point out that highly leveraged carriers are not immune from the effects of the market place. They cannot raise fares above what the market rate would be.

They do not necessarily operate more efficiently than nonleveraged carriers, but I think it is important to note that price competition would still be there. I have heard this theory about more debt equals higher fares, and again it just does not fit with my analysis of the industry.

Senator MCCAIN. But you would agree that, in the case of a downturn in the industry, they are much more vulnerable to those economic factors?

Mr. PETTEE. That is correct. In fact, I am forecasting about a 20 or 30 percent decrease in earnings next year, which is a little bit ironic given the fact that these LBOs have been occurring and as I mentioned, one of the catalysts is the expectation that the earnings and cash flow levels that we have seen in the last 18 or 24 months, which have been at record levels, will be sustainable.

Senator MCCAIN. Therefore, if the LBOs continue, and the airline industry's economy takes a downturn, then these airline industries are in some financial jeopardy.

Mr. PETTEE. If not managed properly, the leveraged transactions in the airline industry could lead, particularly in a period of a significant downturn or a recession could lead to another bankruptcy, a significant bankruptcy. I would not doubt that fact in the likelihood of a recession or significant downturn.

Senator MCCAIN. Under what conditions, if any, should we allow a foreign airline to rescue a failing domestic airline?

Mr. BEAUVAIS. I think it is pretty clear we have to abide by the restrictions on ownership. It should not exceed 25 percent. A foreign invested company, whether it is an airline or not, should not have control of a U.S. carrier.

I think the prior conditions that have been enforced by the DOT in the past and the CAB in the past are valid, and I think those should be very carefully adhered to and I think the company

should be clearly managed by U.S. citizens and I do not think there is a shortage of financial resources in the U.S. that would preclude that from happening, if a company has a valid opportunity for success somebody will be there to try it.

Senator McCain. There have been stories, including one recently in the "Wall Street Journal" about how a major airline, when seeing that a small airline is starting to make a route lucrative, moves into that route, lowers its fares and basically drives that smaller airline out of that particular sector of the market. Have you had that experience?

Mr. Beauvais. Oh, definitely. It is a tenacious, competitive environment that we are in, and when America West started servicing Phoenix we experienced that very action on behalf of Southwest Airlines. As a matter of fact, they are still up to that.

So when we confront each other on a wing tip to wing tip basis, the fare levels are lower than our costs and we are both losing money, but we have been able to manage the company in a way to a point where we have grown away from that and we are now profitable, but we still lose money on those routes, and it is a very tenacious type of confrontation.

Because when you look at our industry——

Senator McCain. To what lengths should that be carried before it becomes anticompetitive? To what lengths should a practice of that nature be allowed to be carried before it becomes an anticompetitive practice?

Mr. Beauvais. Well, of course, the antitrust laws deal with that. If they are enforced, then the interests of the industry are protected in order to preserve the competitive atmosphere.

I am just underscoring the fact that we do have a tenacious, competitive atmosphere in our industry, and to a certain extent the kind of competition that an upstart, or new entrant in the industry, faces. It is much more formidable than what the established carriers conduct against each other.

For example, United is not trying to drive American out of business in Chicago, nor is American trying to drive United out of business in Chicago, but Southwest has definitely been trying to drive America West out of business in Phoenix.

That is what the new entrant experiences, until they can demonstrate they can handle it. Then people become more rational, and we assume at some point in the future that will happen for us, because we have demonstrated that we can handle it, but we are one of a few. Midway Airlines and America West are the only two postderegulation airlines of any size that have been able to handle the competitive condition.

Presidential Airways started with a hub and spoke system at Dulles. United proceeded to overlay their route system on top of Presidential and drive them into submission. So most carriers are able to do that in the U.S. domestic environment, and it still is the case.

Senator McCain. And the overall result is fewer and fewer airlines——

Mr. Beauvais. That is quite apparent, yes.

Senator McCain. So, what action would you recommend?

Mr. BEAUVAIS. I think it is very important to recognize the comments of Secretary Skinner, and that is the oversight responsibilities on behalf of the Department of Transportation and also the Senate and Congress is to make sure that we have a genuinely competitive industry.

The decisions that have to be made with respect to the impact on our industry should be decisions that say is this good for the competitive atmosphere and our industry.

If you can say yes, then you are making the right decision.

Competition will breed efficiency. Competition will produce the best fare for the consumer. Competition will produce an industry that is capable of growing to its full potential, and I think those are the decisions that have to be made.

Senator MCCAIN. Besides all the aspects of esprit de corps, outstanding leadership and all those other intangibles, how do you account for the fact that America West survived and Midway survived and the others have not?

Mr. BEAUVAIS. I think at this time several factors. Number one, adequate capital. I think what we saw at Braniff last week was a prime example of the issue of adequate capitalization of a company when they go into an industry like this.

You have to recognize the competitive atmosphere and, therefore, capitalize appropriately, and that is very hard to do. But, I believe that Midway and America West fit that picture in that we have always been adequately capitalized.

And you have to have a very good market niche, and you have to know what it is and you have to be able to be very aggressive in developing your company so that you can grow it to a point where it can compete with any carrier in your market niche.

Senator MCCAIN. Thank you very much.

Thank you, Mr. Chairman.

Senator FORD. Thank you.

I hope you gentlemen would allow us, say, for the next couple of weeks to—if something comes up, if we could submit questions to you in writing that you could respond to us fairly quickly.

We appreciate both of you coming this morning. I know it was a little bit of a hardship, but your input will be very helpful in our discussion and hopefully legislation that will be good for the industry and not harmful.

Thank you all very much, and this hearing is adjourned.

[Whereupon, at 10:32 a.m., the committee adjourned subject to the call of the Chair.]

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